Special Committee on Aging
United States Senate

Hearing for

Living Stronger, Earning Longer: Redefining Retirement in the 21st Century Workplace

Testimony Prepared by

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Chairman Smith, Ranking Member Kohl and distinguished committee members, thank you for the opportunity to testify on "Redefining Retirement in the 21st Century Workplace." My name is Valerie Paganelli, and I am a senior retirement consultant for Watson Wyatt Worldwide. Watson Wyatt is a global human capital consulting firm. We are a major provider of actuarial and consulting services to retirement plan sponsors in the United States and around the world. Our consulting is grounded in the most extensive research in the business. As a firm, we have long been engaged in research concerning the changing demographics of the U.S. labor force in general and phased retirement in particular. We appreciate the opportunity to provide our perspective on phased retirement with you today.

General Comments

Employers face varying levels of urgency around extending the working years of their employees up to and beyond what has been regarded **as** Normal Retirement Age (i.e., age 62 to 67). The level of such urgency is governed by a number of factors: industry of operations, the critical skill sets that drive the business and create competitive advantage, the geographies in which the business operates, the current and projected demand for specific goods and services, the current demographic landscape and retirement financial preparedness of the employee population, and the underlying culture of the organization. When it comes to phased retirement programs, those companies with moderate to high urgency are challenged to formulate an alternative approach to traditional retirement programs and patterns that meet the day-to-day needs of both their business and their employees. There is generally a strong desire among employers to retain and engage employees who continue to contribute to the ongoing success of the business.

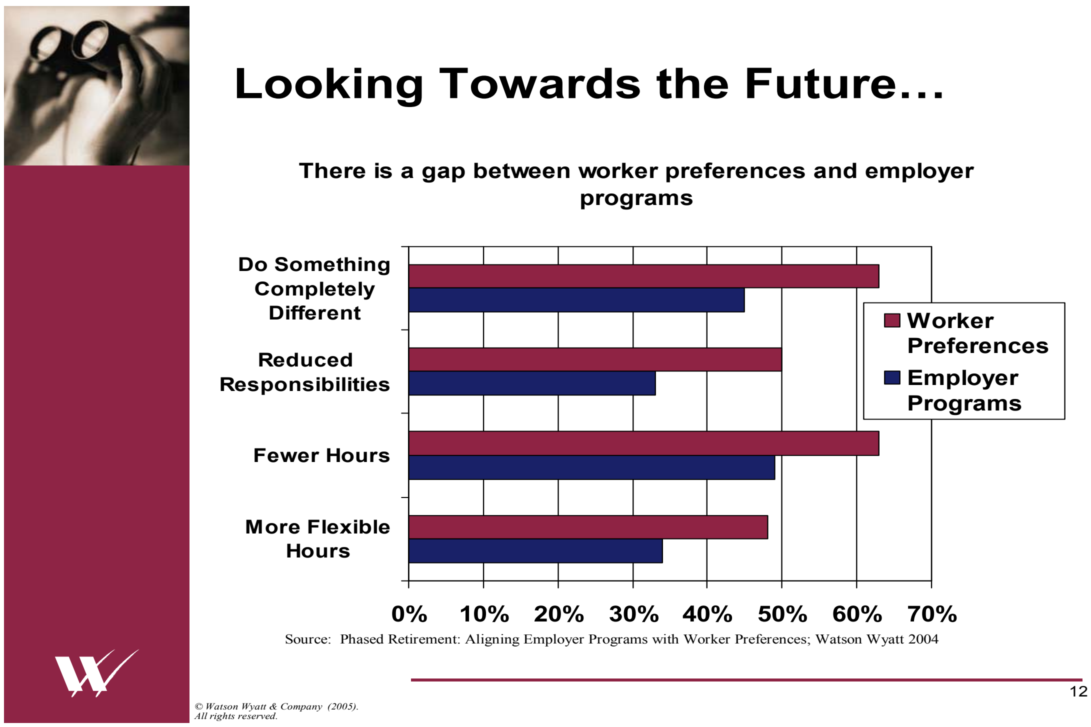
Many employers are at an interesting workforce management crossroads: the dire need to keep some retirement-eligible employees while allowing others to exit through intended patterns supported by existing retirement programs (including temporary voluntary early retirement programs). The opportunity for flexible and targeted retention of only a portion of the retirement-eligible population poses significant employer challenges and risks. Employers would also like to know there is the opportunity to provide a level playing field such that employees can be allowed to stay put with their current employer in the same way as if they left to work somewhere else. The current legal framework for qualified retirement plans and general employment laws preclude employers from providing such a playing field.

Employers wishing to retain their older, more experienced workers are actively exploring strategies to encourage these workers to phase rather than retire completely. This will alleviate some of the pressure that the coming labor shortage is likely to create. It will also help employers avoid losing skilled and experienced workers to competitors and other employers that offer phased retirement options. However, a number of legislative and regulatory obstacles currently stand in the way of formal broad-based phased retirement programs.

Phased retirement thus far has been predominantly driven by employees who retire from one organization and return to work for another organization or return to their pension-paying employer on a consulting or contract basis. One-third of surveyed workers over age 50 are willing to work longer with their current employer if they are offered informal phased retirement programs such as flexible work arrangements, reduced working hours and/or less job responsibility, and the opportunity to try something new. And nearly one-fourth of older workers currently phasing into retirement expect to work past age 65, while another 20 percent do not plan to retire at all. The clear implication is that phased retirement programs can support older workers to remain in the workforce and increase the supply of experienced workers over the coming decades.

Phased Retirement Incentives

Despite clear interest in phased retirement by both employers and employees, sizable gaps exist between the types of programs workers want in order to phase into retirement with their career employer and what employers currently allow in terms of such opportunities.

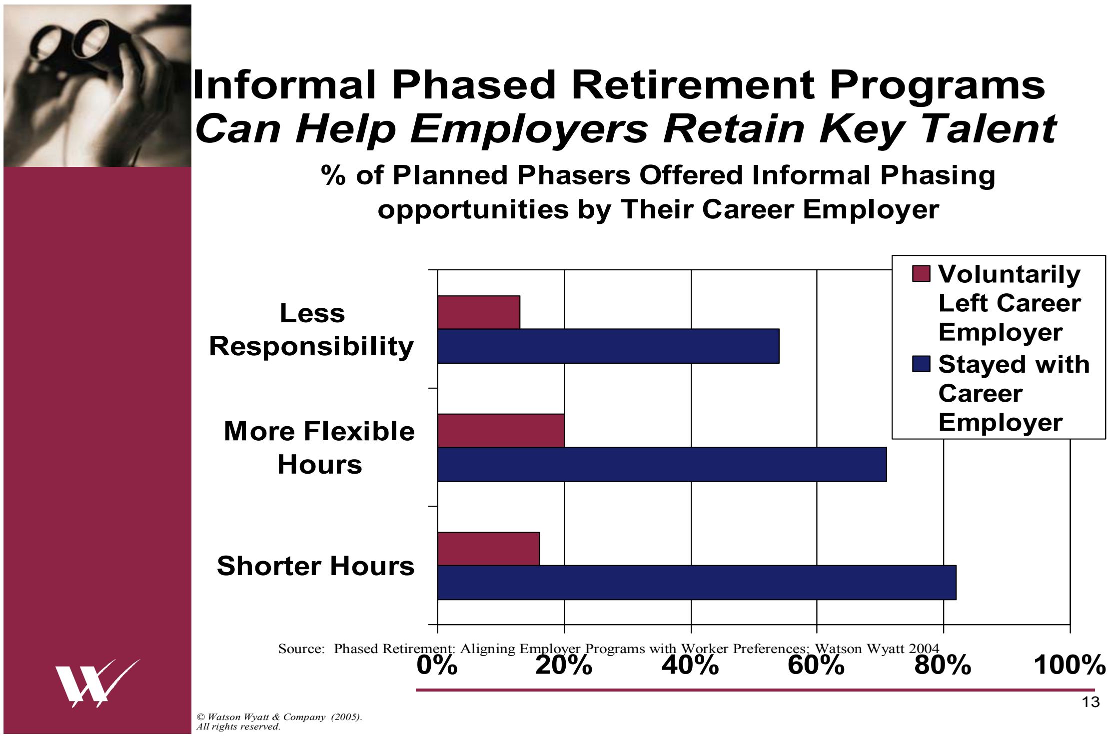


A variety of incentives exist to keep older workers engaged in the workforce. From a financial perspective, phasing can provide more income than full retirement at the same age and enables retirees to stretch savings over a life that is expected to be longer than that of earlier generations. A typical male worker today is projected to spend five more years in retirement than the worker of 40 years ago.

Of recently surveyed voluntary phasers (57% of all phasers), 28% indicate income needs as the reason for their phased retirement. For unplanned phasers, this percentage increases to 40%-58%. Thirty-eight percent who voluntarily left their career employer are receiving a monthly pension. The traditional three-legged stool of retirement income made up of Social Security, employer pension and personal savings is no longer the appropriate financial planning framework for future retirees. The unsettled debate on Social Security, escalating cost of medical care, reduction of workers covered by defined benefit pension plans, and the potentially less-than-adequate savings patterns in the US make for an unstable financial retirement stool for many individuals. Phased retirement and the role of continued wages from active employment will become more and more necessary as an added dimension to “rest-of-life” financial planning.

But extra income is often not the reason people chose to “work in retirement.” The most common reason for continuing to work among those currently in voluntary phased retirement is enjoyment, indicated by 42% of surveyed voluntary phasers. These phasers who work primarily for enjoyment are more likely to experience higher job satisfaction, enjoy good health and receive higher pay raises than their peers and thus are likely more productive.

Phased retirement programs and access to other benefits meaningful to an aging workforce can encourage older workers to continue working. Voluntary phasers are much more apt to stay working for their career employer if informal phased retirement arrangements are available. In particular women are shown to extend their careers by up to 21 months when phased retirement arrangements are available and men are shown to extend their careers by eight months when eldercare services are available. When last surveyed, anywhere from 16% to 40% of employers offer phased retirement or generally available flexible work arrangements and only 27% of employers provide for eldercare services.



A combination of financial and regulatory obstacles forces many workers to abandon their career employers and seek phased retirement elsewhere. Nearly one-third of those who left their career employer and found new jobs are performing similar work. If phasers working less than full time cannot take advantage of qualified pension or other employee benefits while continuing to work with their current employer, they may need to switch employers in order to maintain an appropriate standard of living.

Phased Retirement Obstacles

The main reason for limited availability of phased retirement programs is the variety of federal rules that generally preclude the use of qualified retirement plans, especially pension plans, to partially fund a phased retirement arrangement.

Two significant types of employer-sponsored benefit plans affect an employee's retirement decision: qualified retirement plans (pension or §401(k) plans) and health and welfare plans. It is important to note the tax laws and preferences for these two types of plans are very different. Qualified retirement plans are funded over an employee's working career in order to substantially, if not completely, pre-fund the individual retirement benefit. Several tax advantages are built into the tax laws to encourage employers' sponsorship and pre-funding of retirement income benefits. In contrast, retiree health plans cannot be more than nominally pre-funded during the employee's active working years; else the employer faces adverse tax consequences. As a result, pay-as-you-go funding is the predominant funding method for retiree health benefits.

As an early retirement incentive, traditional retiree health benefit plans were very successful. One study demonstrated that providing such benefits resulted in an almost 70 percent increase in employees' propensity to take early retirement. Many employers who have offered temporary voluntary early retirement programs have discovered that the presence of retiree health benefit coverage may be the singularly most important element in encouraging workers' early retirement.

While employers' health care costs for active employees have grown dramatically in the last several years, the additional expense associated with retiree health benefits looms large and has caused many employers to limit their post-retirement health care obligation to employees. This leaves many employees with the additional financial burden of providing for their own health care needs in retirement and may require continued employment to bridge access to Medicare coverage starting at age 65.

Our retirement system in the United States has been very dynamic during its evolution, responding to the conditions, needs and protections of employers and workers over the decades. As the system has evolved, however, a substantial body of regulations has grown up around it to control the operation of retirement plans. The net effect of these regulations has been to limit the flexibility of the pension system. As the labor markets continue to change because of forces outside the control of the regulatory environment, pension regulations must be adapted to meet future needs; otherwise we limit the continued utility of pensions and may fuel adverse macroeconomic effects as well.

One of the most significant barriers to formal broad-based phased retirement arrangements is the prohibition against pension distributions to actively working employees who have not attained normal retirement age. The foundation of the restriction is the regulatory definition of a pension plan as providing for the payment of benefits "after retirement." This requirement has resulted in a restriction against pension plans distributing benefits to participants prior to severance of employment or attainment of normal retirement age. The IRS has recently proposed new guidance that would change this rule and permit certain phased retirement distributions, but would impose significant administrative burdens and limited flexibility such that very few employers have expressed interest in providing such a benefit to older workers.

Employer Actions

Despite the lack of existing facilitating legislation related to qualified pension plan distributions, many employers are actively exploring phased retirement arrangements for their aging workforce. There are myriad activities and approaches that are being considered and practiced:

- Reviewing existing benefit programs to identify areas of opportunity to facilitate phased retirement based on the particular needs of the organization and its employees.
- Making use of other employee pay and benefit programs outside of their qualified pension plan, such as health care, direct compensation, incentives, flexible work arrangements, reduced working schedules and responsibilities, alternative work assignments, eldercare and other assistance services.
- Rehiring bona fide retirees as part-time employees and/or independent contractors on a targeted basis.
- Recruiting targeted at the retiree ranks of their own and other organizations.

- Understanding the organizational culture, leadership, communication, succession planning and training that must accompany a more broad-based phased retirement program.
- Quantifying the cost/benefit of extending the working years of existing retirement-eligible workers as compared to the supply and availability of replacement workers.

The urgency, opportunities, and decisions are unique to each organization. Those employers with a desire and need to create a competitive advantage by offering phased retirement recognize they may experience increased costs associated with retaining their existing aging human capital resources.

Policy Recommendations

We believe the prospects for encouraging older workers to remain in the workforce for longer periods exists using phased retirement programs, but there is much to do in order to support employers to offer and workers to accept phased retirement arrangements. We would like to encourage policy makers to actively:

- Encourage the coordination of DOL, EEOC, and other appropriate governmental entities to facilitate the changing landscape of retirement in the United States.
- Provide for phased retirement distributions from qualified defined benefit plans. The current inability to permit distributions for pre-normal retirement age active employees who want to reduce their work schedules but maintain their employment relationship with their current employer is a significant hurdle for phased retirement programs.
- Endorse defined benefit plans. The flexibility of plan design necessary to foster phased retirement has been a hallmark of defined benefit plans. Phased retirement benefits can be supplemented by the employer under a defined benefit plan in ways that simply are not possible in a defined contribution plan.
- Establish a framework for Americans to understand and practice the key components of successful retirement income planning (e.g., comparable to the food pyramid for encouraging healthy, balanced eating habits).
- Continue conversations with employers, employees and their representatives.

Closing

I want to thank you for holding this hearing. Our firm believes the nation faces unprecedented retirement policy questions. We need as many tools as possible to deal with the associated challenges. The form and construct of our current retirement programs, as shaped by demands of the most recent decades, does not adequately contemplate changing forces. It is imperative we allow for the flexible unfolding of alternative profiles of retirement. The concept of phased retirement and any supporting regulations, legislation or laws are an integral part of the changing landscape; it sets the foundation for a new meaning of retirement in our country.

Watson Wyatt would be pleased to continue to contribute to your discussions of the new definition of retirement in the 21st century. Thank you very much for the opportunity to appear today. I would be pleased to answer any questions you may have.